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DIRECT COSTING VERSUS
ABSORPTION COSTING

Billy Glenn Waller

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DIRECT COSTING VERSUS ABSORPTION COSTING

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1959

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CHAPTER I

INTRODUCTION

Managers of business enterprises have always been primarily concerned with earning profits. This is particularly true for present-day businesses in an era of growing unionism, government intervention, and public demand for environmental control. These factors naturally vie for portions of the industry dollar and make management think more creatively in order to earn profits in spite of increased demands on corporate earnings. Profits are the primary measurement for success in most business organizations. Managers must be increasingly aware of the tools available to assist them in reaching correct decisions which will maximize company cost versus benefit relationships in all areas of the firm's undertaking.

One tool available to the manager is cost accounting. Evidence of cost accounting techniques as tools for managerial decision making can be found as far back in history as 1492. During this period, Venice, a maritime power, had in operation its own government owned shipyard. Almost two thousand workers were employed by the Venice Arsenal. The efficiency of the managerial staff of this early shipbuilding complex is largely

attributed to managerial use of cost accounting in aiding their decision making.¹

A merchant who buys at wholesale and sells at retail has only to look at his purchase invoice to determine his cost for each item sold. The manufacturer who produces goods has the additional problem of determining the proper value of the labor, materials, and overhead expended in producing those goods. This, in essence, is what cost accounting is all about--the attempt to give the producer of goods a cost of his produced product for translation to financial statements.

Management sometimes does not understand cost accounting as it relates to the financial statements of his organization. The use of the term "cost accounting" implies that cost accounting should be entirely distinguishable from what we consider the normal system of accounting. This is not so. Cost accounting is but an extension of general accounting. Long before the term "cost accounting" was used the general financial accounting methods reported costs in aggregate form for management control. Cost accounting simply breaks down aggregate costs on a unit or functional basis. The unit is usually a plant, department, product line, or other unit to which costs can be assigned.²

¹Claude S. George, Jr., The History of Management Thought (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1968), p.33.

²Carl L. Moore and Robert K. Jaldicke, Managerial Accounting (Cincinnati: Southwestern Publishing Company, 1963), p.271.

One reason for management's failure to understand the relationship between cost accounting and financial statements is that often accounting reports fail to confirm the manager's advance planning estimates and his intuitive judgment of what the profit should be for his firm for a particular accounting period. One classic example of this is a period during which sales increase but profits decline. Another example is a period when profits increase but sales volume is down from previous periods. The answer to these two seemingly paradoxical situations is obvious to the accountant skilled in the mechanics of how fixed costs can be tied up in inventory or released when these inventories are sold. To some managers, however, these situations are indicative of archaic accounting systems which are not responsive to their current needs for cost information. Intuitively, the manager feels that during a period in which sales rise to new record highs, profits should be correspondingly high. When such is not the case, he not only thinks something is remiss with his system of accounting, but is often in a receptive mood for a change to something different, and hopefully, an improvement over the old system.

In response to the desire for greater understanding of cost accounting itself and the need for improved tools as aids to the decision making process, direct costing has emerged in recent years to challenge absorption costing as the preferred method of cost accounting. Many firms have experimented with this new

system. Some have adopted it for internal use only. Some use it for both internal and external reporting although the use of direct, or variable costing, as it is sometimes called, for external reporting is rare due to its general non-acceptance by the American Institute of Certified Public Accountants, (AICPA), the Internal Revenue Service, (IRS), and the Securities and Exchange Commission, (SEC). The IRS and SEC have been strongly influenced by the AICPA in this attitude toward direct costing.¹

It is this challenge to the customary method of applying overhead costs to products which has prompted this thesis. This paper will attempt to answer such questions as: Should the traditional absorption method of cost accounting be replaced by the direct costing method in industry? What has been the trend to date toward the use of direct costing? What are the advantages and disadvantages of both methods? Will management accept direct costing? Can objections of the American Institute of Certified Public Accountants, the Internal Revenue Service, and the Securities and Exchange Commission be overcome? What is the future of direct costing? Another objective is to compare the direct costing method to absorption costing and reach conclusions as to which method more effectively gives management the better tools with which to reach correct business decisions.

Research for this thesis encompasses all significant

¹Richard M. Lynch, Accounting for Management: Planning and Control (New York: McGraw-Hill Book Company, 1967), p. 299.

literature on both direct and absorption costing. Jonathan N. Harris, controller of the Dewey and Almy Chemical Company, is generally credited with one of the earliest written contributions to the field of direct costing with the publication of an article entitled "What Did We Earn Last Month?" in 1936. This article has become an accounting classic. Since then hundreds of articles have appeared in management and accounting journals on this controversial subject. Direct costing has also been incorporated into most accounting textbooks in varying degrees. The National Association of Accountants has twice issued research studies on the subject. In April, 1953, Research Series No. 23 on "Direct Costing" was issued. Eight years later this study was superceded by NAA Research Series No. 37. The degree of interest in direct costing is evidenced by the fact that Research Series No. 37 was requested by more interested users than all previous research studies combined.¹ The subject of direct costing can be found increasingly in textbooks and journals on general management theory. From the above mentioned sources will come the information to form deductive analysis and for reaching conclusions concerning the subject of direct versus absorption costing.

This paper will be limited to non-technical aspects of both methods of costing insofar as possible. Nor will the technicalities of implementing either system in an industrial application

¹Raymond P. Marple, ed. National Association of Accountants on Direct Costing. Selected Papers (New York: The Ronald Press Company, 1965), pp. 12-13.

be considered within the scope of this study. It is recognized that, to a considerable extent, a semantic mungle exists in this area. Such terms as variable, marginal, direct, fixed cost, sunk costs, period costs, and a host of others can be confusing when used interchangeably with one another. Hopefully, the exact terms will be defined where necessary for clear understanding by the readers of this paper. It is also recognized that not all costs can be classed as either fixed or variable. Some costs are semivariable. The position is taken here that management can solve this dilemma by arbitrary management decisions, i.e., by classifying all costs as either variable or period expenses.

The author would like to think that this thesis might contribute something to the accounting profession. However, it is not aimed at accountants only. On the contrary, the theme of this study is intended for the manager of business enterprises rather than the accountant.

The approach for presentation of this study will be to divide the material into six chapters. Chapter One has been the introduction. Chapter Two will present the genesis of direct costing. Here the objectives of any cost accounting system will be presented along with the developments leading up to the new method of cost accounting. One reason accountants came to advocate direct costing was that absorption costing was

not providing management with the proper cost information on which to make alternative business choices. The inability of absorption costing to provide management's needed cost information is covered in Chapter Two. Chapter Three will present advantages and disadvantages of each method and Chapter Four will cover the managerial uses of direct costing. The acceptance of direct costing by management, the Internal Revenue Service, the Securities and Exchange Commission, the American Institute of Certified Public Accountants and the accounting profession as a whole will be the subject of Chapter Five. Chapter Six will give a summary and the conclusions reached as a result of empirical research conducted and presented in the first four chapters of the thesis.

Terminology

Direct costing is also known as marginal costing and variable costing. All three terms are synonymous in the field of cost accounting. Gordon Shillinglaw, an authority in the field of cost accounting, prefers the term variable costing to direct costing. He claims the term direct costing is misleading and states:

As it is used in other contexts, the word 'direct' implies a high degree of traceability of the cost to specific costing units. Thus direct labor is labor cost that is traceable to specific job orders or process flows: direct departmental charges are those that can be identified

specifically with a given department. Much overhead that is variable in response to changes in production volume, however, is not specifically traceable to individual products or even to specific production departments. For this reason we prefer to use the term variable costing in describing cost absorption systems that recognize the distinction between fixed and variable costs.¹

Other authors agree with Shillinglaw that the term variable costing would be a more appropriate term than direct costing since those costs identified with direct costs are the variable costs of production.² Nevertheless, Jonathan Harris' "direct costing" term has caught on more solidly and seems destined to win out in the war on semantics over naming this new approach to cost accounting.

J. H. Rushton defines direct costs as "those that 'vary directly and proportionately with volume,'... 'and which can be conveniently identified with a product or an operation'."³ Fixed costs are costs of providing capacity to produce and which expire with the passage of time. Fixed costs, for given capacities, remain constant without regard to the rise and fall of production. Of course, it must be recognized that in the long run management can influence fixed costs. Other terms having slightly different connotations which are sometimes

¹Gordon Shillinglaw, Cost Accounting, Analysis and Control (Homewood, Ill.: Richard D. Irwin, Inc., 1961), p. 613.

²Charles T. Horngren and George H. Sorter, "Direct Costing for External Reporting," The Accounting Review, Vol. XXXVI (January, 1961), p. 34.

³J. H. Rushton, "Cost Accounting Gets Its Hair Cut," in NAA Selected Papers on Direct Costing, ed. by Marple, p. 114.

used to refer to fixed costs are "time," "period," "standby," and "sunk" costs.¹

Direct Costing Defined

Since Jonathan N. Harris published what he described as a "true-story, fiction-type" article in the NAA Bulletin in early 1936,² proponents of direct costing have been advocating the replacement of absorption costing with direct costing. Others have proposed various combinations of the two methods.³ Those who prefer the absorption method contend that product costs should include all manufacturing costs and the latter group are currently still in the majority.⁴

Waldo Neikirk has defined direct costing as follows:

Direct costing should be defined as a segregation of manufacturing costs between those which are fixed and those which vary directly with volume. Only the prime costs plus variable factory costs are used to value inventory and cost of sales. The remaining factory expenses are charged off currently to profit and loss. However, the point to be emphasized is that direct costing is primarily a segregation of expenses and only secondarily a method of inventory valuation. By this approach, full attention can be directed to the effect which direct costing has on the profit and loss statement and supplementary operating reports.⁵

¹Ibid., p. 115.

²Marple, NAA Selected Papers, p. 8.

³Letricia Gayle Rayburn, "Direct Costing and Absorption Costing," The National Public Accountant, pp. 22-28. Also see David Solomons, Divisional Performance, Measurement and Control (Homewood, Ill.: Richard D. Irwin, Inc., 1965), p. 111.

⁴Shillinglaw, Op. Cit., p. 291.

⁵Waldo W. Neikirk, "How Direct Costing Can Work for Management," in NAA Selected Papers, ed. by Marple, p. 83.

Some advocates as well as opponents of direct costing view it as simply a plan for the elimination of fixed cost from the inventories of the firm. As pointed out in NAA Research Series No. 23 on Direct Costing, "this description stresses an incidental feature rather than the prime objective of the plan, which is provision of information about cost-volume-profit relationships."¹

Absorption costing treats all the overhead cost of the manufacturing organization as product costs. Direct costing, on the other hand includes in the product "only the variable elements of manufacturing overhead, treating fixed costs as a general charge against all operations combined and not against any specific segment of operations."²

Jonathan N. Harris can be considered the "father" of direct costing. He defined direct costing as follows in one of his early writings on the subject:

Direct cost accounting is regular standard cost accounting after an operation for chronic appendicitis. The useless appendix known to many readers, as unabsorbed or over-absorbed factory burden, has been eliminated. By this operation standard cost accounting requires ability to provide management with truthful income statements where before, the real results are obscured by technicalities.³

¹"NAA Research Series No. 23: Direct Costing," in NAA Selected Papers, ed. by Marple, p. 184.

²Shillinglaw, Op. Cit., p. 611.

³H. W. Luenstroth, "The Case for Direct Costing, " in NAA Selected Papers on Direct Costing, ed. by Marple, p. 101.

Basically then, in direct costing, all fixed costs are recognized as expenses of the accounting period in which such costs expire, and furthermore, are taken directly to the business firm's income statement without going through the product inventory accounts. Not only do absorption costing and direct costing lead to different measures of income for specific periods but the latter provides for an aid to measure the relative profitability of individual products, territories, or other breakdowns of the company's business.¹

¹Shillinglaw, Op. Cit., p. 612.

CHAPTER II

GENESIS OF DIRECT COSTING

Objectives of Cost Accounting

Cost accounting is conducted to provide management with the data necessary to run the internal operations of the business enterprise. It differs in many respects from financial accounting. It is an optional accounting system and is not governed by generally accepted accounting principles. It focuses on segments as well as on the whole of business and generally has more than one purpose. Costing has less emphasis on precision than financial accounting and is a part of other processes, rather than an end in itself.¹

The principal objectives of any method of cost accounting are as follows:

1. To arrive at proper inventory values and thus match expense with related revenue properly.
2. To enable management to control costs.
3. To provide information upon which to base selling prices, where market conditions are such as to give the company some degree of control in this respect.

¹Robert N. Anthony, Management Accounting, Text and Cases (Homewood, Ill.: Richard D. Irwin, Inc., 1970), p. 352.

4. To furnish management with data necessary in making decisions relating to such problems as marketing new products, intensifying or reducing sales effort for certain products and territories, revising product lines, introducing labor-saving machinery, purchasing more expensive materials to increase production speed and thus decrease labor and manufacturing expense, rejecting or accepting business at prices below normal, etc.¹

The purpose of financial accounting is to furnish outsiders with information sufficient to evaluate the financial condition of the business enterprise and the efficiency of its management. The purpose of cost accounting, on the other hand, is to be responsive to the needs of management for correct information on which to base decisions for profit making. The information needed by management may be used for such diverse purposes as performance appraisal, price determination, or for planning long and short-range strategies. The extent of the information to be gathered is optional and is determined by management. "The basic question in management accounting is the pragmatic one: 'Is the information useful'? rather than, 'Does it conform to generally accepted principles'?"² In summary, the objective of cost accounting is to provide data for financial statements and to facilitate managerial reporting, planning, and control. The objectives of cost accounting has much in common with other management information systems.

¹Joseph A. Mauriell, "Convertibility of Direct and Conventional Costing," in National Association of Accountants on Direct Costing, Selected Papers, ed. by Raymond P. Marple (New York: The Ronald Press Company, 1965), pp. 159-160.

²Anthony, Management Accounting, p. 352

Absorption Accounting

Cost accounting as applied to manufactured products has relied, for the most part, upon a theory of "full" or "absorption" costing. The cost accountant has attempted to ascertain a cost of manufactured product which, when appearing on financial statements, would correspond to the merchant's invoice cost of goods sold. In assigning costs to products, the cost accountant has traditionally adhered to only one principle of product costing: the cost assigned to a product should be the sum of the direct costs incurred in producing it, and a fair share of the indirect costs. Nevertheless, satisfactory methods of accumulating product cost evolved to enable the cost accountant to assign both direct and indirect costs to products. These methods were job costing and process costing.

The determination as to whether fixed costs are period costs or costs which should be attached to the product is basic to the principle of absorption cost accounting. In absorption costing all costs in the manufacturing area end up being charged to some specific product or products. This means that fixed costs such as equipment depreciation, security, and insurance costs are charged to inventories. This is done either on an actual basis or on a predetermined amount of overhead usually

based on normal volume of production. In essence, these fixed costs captured into ending inventories are deferred expenses until the products are sold. Under absorption costing fixed costs for a period are carried to cost of goods sold or capitalized in inventory. Net income will be significantly affected as inventories fluctuate from period to period.

When production for a period exceeds sales, absorption costing will yield a higher profit than would cost accounting under the direct costing concept. The obvious reason for this is that absorption costing will have deferred a portion of the fixed expenses of the period to future periods. Conversely, when sales exceed production, absorption costing will show a lower profit than would direct costing. Of course, this is attributed to the fact that fixed costs which were previously deferred in inventory are now charged to income during the period in which they are sold.

By allocating all costs to products absorption costing avoids considerable fluctuations in inventory values, but at the expense of distorted income figures. When production is increased, in absorption costing fixed costs are built up in inventory and are not charged off until the inventory is sold. Often inventory building is accomplished long before planned sales catch up. Under the absorption costing method profits will go up during the production periods even though sales are

not yet rising. By the time the increased sales rise as expected production volume may be down. Thus when sales are at their highest profits may dip. This is not easily explained to management. The manager is often mystified when income seems to have no relationship to sales volume.¹

Management Needs Not Satisfied
by Absorption Costing

As management became more interested in the cost-volume-profit relationship, it became evident that absorption costing rendered inadequate information for this type of analysis. It was often found necessary to make detailed special studies in order to obtain required information used for decision making. Thus, management must often work with several sets of data to find the cost-volume-profit relationship within the firm. If breakeven costs were wanted by management separate breakeven analysis data was requested either in the form of charts or other statistical form.

Management requires much statistical information in making decisions which involve alternative choices. Financial statements resulting from absorption costing methods provide little insight into decision making such as determining current prices, determining at what volume to produce, evaluating proposals for cost reductions, making decisions on the purchase of minor items

¹Ralph W. Sauber, "Management Appraises Direct Costing--A Play," in NAA Selected Papers, ed. by Marple, p. 124.

requiring capital expenditure, deciding whether to make or buy parts or sub-assemblies and whole assemblies, and deciding upon whether to add or to drop a given product.

Is there an alternative to absorption costing which will provide management with more meaningful cost information? Many proponents of direct costing claim this costing method will fill management's need for more meaningful cost information. The emergence of direct costing gave accountants and management a different view of which cost elements should be assigned to products. This view represented quite a different view of which costs should be applied to the product as opposed to what had traditionally been applied to products via overhead rates using full or absorption cost methods. Direct costing "assigns to products only those manufacturing costs that are variable in response to short-period fluctuations in production volume."¹

Development of Direct Costing

The development of direct costing probably began when the cost accountant for the first time noticed the impracticality of waiting for end-of-period actual costs to apply to products in arriving at the actual cost of products produced during some specific accounting period. To satisfy this impracticality, predetermined overhead rates came into being as a means to obtain cost information prior to the end of an accounting period. Also "product costs which fluctuated widely in inverse relationship

¹Shillinglaw, Cost Accounting, p. 291.

with production activity seemed inappropriate as a base for determining selling prices."¹ Thus predetermined rates for applying overhead naturally evolved as a matter of course in an industrial setting where competitive prices of products could not fluctuate depending upon volume of production for a particular period. That is, prices could not fluctuate widely and remain competitive in an increasingly technological world. The primary purpose for establishing predetermined overhead rates was to get product cost information prior to the end of the accounting period. More consistent product prices was one of its chief benefits.

As overhead burden assignments gradually came to be recognized as accepted practice and product cost figures including factory overhead costs began to be used for pricing products, weaknesses of historical overheads became obvious. Managerial decisions such as product pricing could hardly wait until the end of an accounting period for actual overhead cost to be calculated and spread over products.

One of the earliest businessmen to recognize this in the United States was Henry Metcalfe. In 1885 he suggested that since overhead items were not known exactly until the end of a period, it was logical to assume relatively little variation from period to period and thus to load work in process with an

¹R. Lee Brummet, Overhead Costing, The Costing of Manufactured Products (Ann Arbor, Mich.: Bureau of Business Research, School of Business Administration, University of Michigan, 1957), p. 8.

amount determined by use of a rate based on the past year or several years experience.¹

There were those who insisted that overhead burden rate predetermination was, while useful for estimating, insufficient as a method to determine formal costs.² They felt that only end of accounting period actual costs were proper for formal record keeping and inventory valuation. Today predetermined overhead rates are taken for granted.

Most literature on cost accounting classifies the allocation of overhead costs to products into the following general purposes:

- (1) The costing of inventories of stocks on hand for inclusion in annual statements of income and balance sheets.
 - (2) The costing of products as a basis for pricing.
 - (3) The evaluation and control of managerial performance.
- Solomons says of overheads, "unless this awareness is sharpened by showing the central expense allocations on the divisional profit and loss statements each month, the division may, in pricing policies and other marketing decisions, plan to contribute less than its due share of the company's net income."³ Other examples: "All factory overhead costs...must be assigned eventually to production departments for product

¹Henry Metcalfe, Cost of Manufactures, (New York: John Wiley and Son, 1900), p. 166.

²Brummet, Overhead Costing, p. 9

³David Solomons, Divisional Performance: Measurement and Control (Homewood, Ill.: Richard D. Irwin, 1965), p. 73.

costing purposes."¹ "Overhead is applied to products because of the managerial need for a close approximation of costs of different products prior to the end of a fiscal period. Essentially, this need is for pricing, income determination, and inventory valuation."²

Anthony says "total indirect cost is properly part of the cost of the total products worked on, and some reasonable part of the total indirect costs incurred must therefore be charged to each unit of product. The procedure...is called allocation."³

While predetermined rates solved one problem for management, it created another which plagues accountants and managers to this day: what to do with the costs which are over- or under-absorbed? The first approach for disposing of these variances was to compute a secondary or supplemental rate. This, however, was too much like returning to application of historical costs or actual costs which was what they were trying to get away from in the first place. Realizing the importance of fixed costs upon net profit, production, and inventory values, accountants began segregating expenses into their fixed and variable components. This allowed computation of budget and volume variances which were invaluable aids

¹M. Backer and L. E. Jacobsen, Cost Accounting (New York McGraw-Hill Book Company, 1964), p. 124.

²Charles T. Horngren, Cost Accounting (Englewood Cliffs, N. J.: Prentice-Hall, 1967), p. 80.

³Anthony, Management Accounting, p. 364.

for management in decision making. However, their disadvantage was that they required long and costly computations separate from the regular cost accounting system output.¹

Separate classification of fixed and variable expenses led accountants to further refine the costing area and led to the flexible budget using standard costs. The flexible budget contains estimates of expenses for all possible levels of output. It readily shows management how fixed cost per unit increases as production declines and that fixed costs decrease when production volume is high. The flexible budget "does not, however, overcome the fixed cost influence completely, inasmuch as a favorable or unfavorable capacity, or volume variance, will result when production does not reach the labor costs, labor hours, or machine hours figures contemplated in the basic budget used to compute the standard burden rate. As long as estimated and actual production are not the same, variances will result."²

Meanwhile, management was recognizing the need to consider variable costs only when considering alternative choices for short-run decisions. Decisions were increasingly made depending upon whether or not a proposal contributed positively to the fixed costs of the organization. Breakeven charts were used in

¹Adolph Matz, Othel J. Curry, and George W. Frank, Cost Accounting, 2nd ed.; (Cincinnati, Ohio: South-Western Publishing Company, 1957), p. 786.

²Ibid., p. 787.

management's profit planning for future periods. At this point both the accountant and the businessman recognized the difference between fixed and variable costs and understood the effect of sales volume on profits. Thus the stage was set for a cost accounting system which could eliminate the end-of-period headache of under-absorbed or over-absorbed variances, render management more meaningful cost-profit-volume relationships, and enable profit to follow sales as management intuitively reckoned it should.

CHAPTER III

COMPARISON OF DIRECT COSTING WITH ABSORPTION COSTING

Relationships Between Absorption Costing and Direct Costing

In NAA Research Series No. 23 on Direct Costing the following six generalizations were made in comparing absorption costing to direct costing:

1. When sales and production are in balance at standard volume, direct and absorption costing methods yield the same profits.... Under both methods, the amount of fixed cost incurred during the period is charged against income of the period.
2. When production exceeds sales (i.e., in-process and finished inventories increasing), absorption costing shows a higher profit than does direct costing.... The reason is that by absorption costing a portion of the fixed manufacturing cost of the period is charged to inventory and thereby deferred to future periods. The total fixed cost charged against income of the period therefore is less than the amount of fixed cost incurred during the period.
3. When sales exceed production (i.e., in-process and finished inventories decreasing), absorption costing shows a lower profit than does direct costing. The reason is that fixed costs previously deferred in inventory are charged to income in the period in which the goods are sold. Total fixed costs charged against income therefore exceed the amount of fixed cost incurred during the period.
4. When sales volume is constant but production volume fluctuates, direct costing yields a constant profit figure

because profit is not affected by inventory changes. Under the same circumstances absorption costing yields a fluctuating profit figure which may move either with or contrary to sales volume,....

5. If production volume is constant, profit is directly proportional to the sales under either direct or absorption costing. The profit figures will move in the same direction, but will not necessarily be the same in amount.
6. The divergence between periodic profit figures computed by direct and absorption costing methods tends to be smaller for long periods than for short periods because differences between production and sales volume tend to approach equality over a long period. Thus the difference between annual profit figures computed by the two methods is usually smaller than the difference between monthly profit figures. Over a period of years, the method should give substantially the same result because sales cannot continuously exceed production, nor can production continuously exceed sales.¹

In the long run either system of costing will produce the same profit figures. This is evident since, in the long run, all costs, including fixed costs, must be recovered through sales prior to entering the area of profitability. The difference in the two systems is in the measurement of interim periods of income. The reason one costing method shows a different income figure for interim periods is explained by the difference in which each treats fixed expenses. This difference causes crucial effects upon the amount of profit of the firm in a given period.

Absorption costing merges direct and fixed costs in the same accounts. Direct costing, on the other hand, separates direct and fixed expenses in the accounts giving them separate identity. Absorption costing attempts to relate fixed manufacturing

¹"NAA Research Series No. 23: Direct Costing," in NAA Selected Papers, ed. by Marple, p. 222

costs to the period when products which receive benefits from the manufacturing facilities are sold. The normal method by which this is accomplished is by allocating fixed costs first to time periods, then to specific products produced during each period. By contrast, direct costing considers the fixed manufacturing expenses as period expenses and consequently charges such fixed costs off to the interim periods as these costs expire.

Absorption costing identifies fixed factory overhead with production, whereas direct costing identifies these same expenses with time and writes them off as period expenses. It follows then that no difference in net income will be reported under the two methods when sales and production volume in a period are the same. Therefore, only two sets of conditions exist which could cause a difference in the reported net income for the same period under the two costing methods: (1) production exceeds sales volume, and (2) sales exceed production volume.¹ The rationale of each of these two conditions is given in generalizations two and three of NAA Research Series No. 23 quoted earlier in this chapter.

Advocates of direct costing conclude that if fixed costs do, in fact, expire with the passage of time they naturally ought to be charged against income of the firm in the period in which they expire. Their contention is that absorption

¹Lynch, Accounting for Management: Planning and Control, p. 231.

costing does not meet this objective because it capitalizes fixed cost as an asset by implanting it into inventories. Thus in absorption costing profit can be shifted from one period to another by increasing or reducing inventory. Proponents of direct costing claim profits are made by selling goods and not by producing goods for inventory. Other factors remaining equal, profits should follow and vary with sales volume. Those accountants who have been swayed to the side of direct costing regard direct costing as a consolidation of the best features of break-even analysis, profit planning, and other recent developments concerning the relationship between volume, costs, and profits.

In summary, the real difference between absorption costing and direct costing is the amount of fixed costs lodged in the inventories. Under direct costing no fixed costs are allotted to inventories. Under absorption costing the amount of increase or decrease in fixed cost in inventory at the end of an accounting period represents the difference in profit results which would have resulted using direct costing.

Advantages of Direct Costing

Obviously the advantages of one system will normally be the disadvantages of the other. For this reason it is not considered necessary to present formally the advantages of both

methods of costing.

(1) Management decision making is enhanced. Direct costing makes it possible to weigh profit implications of alternative courses of action without waiting for detailed special studies. The amount of fixed costs which must be covered before the firm begins making a profit is readily apparent in direct costing. Information for appraisal of marginal products is also readily available from income statements produced under the direct costing method.

(2) Management is given a clearer picture of responsibility of junior management and supervisory personnel. All costs presented are those directly incurred by the person in charge and are not obscured by application of fixed burden. Thus, the uncontrollable costs are never charged to the manager or supervisor who can have no effect on them.

(3) Elimination of fixed factory overhead and consequently doing away with under-and over-absorbed burden problems.

(4) Direct costing facilitates the reporting of profit contribution by product, customer, territory, or salesmen.

(5) "Flash" income reports can be made available to management on short notice based on changes to forecasted sales as any situation may arise to alter sales projections.

(6) Make or buy decisions are made possible without need for special analysis studies.

(7) Direct costing provides management with faster data for

planning, cost control, and financial reporting. Thus a minimum of additional special statistical studies are required. This results in cost savings since less special statistical studies result in savings in manpower and paperwork.

(8) Revised income and expense statements will result which are no longer confused by technicalities. At least one author thinks that control reports which are prompt, reliable and comprehensive are the biggest advantage resulting from the use of direct costing.¹ Statements under the direct costing method will reflect profits in relationship to sales rather than production. This will be easier for the accountant as well as the manager to understand. The separation of direct costs and variable costs on the expense statements emphasizes the cost-volume-profit relationship. The break-even point will be obvious from information on the income statement alone. A quick analysis of the break-even point can be made by simply dividing the fixed expense overhead expenses by the percentage that merchandising margin is of gross sales.²

(9) Interdivisional transfers of products are made easier by direct costing when products are transferred interdivisionally on the basis of variable cost.³

(10) Direct costing causes inventory costs to correspond

¹Luenstroth, Op.Cit., p. 107.

²Neikirk, Op. Cit., p. 85.

³Solomons, Op. Cit., p. 206.

closely with current out-of-pocket expenditures necessary for the manufacture of goods.

(11) Communication is enhanced under the direct costing method. Obviously, if the above are true advantages, then direct costing provides a better communication device than does absorption costing. The elimination of the under- or over-absorption alone eliminates the need for much explanation to management by cost accountants as to the reasons for profit behavior contrary to current sales volume and thus to management's expectations. The elimination of the necessity for detailed statistical reports makes for clearer communications due to lower volume of required readings for decision making. When faced with multiple sets of statistical figures in addition to the accounting statements, management, even when not confused, waste time in studying the different statements and reports.

Disadvantages of Direct Costing

The disadvantages of direct costing listed below may well be considered as advantages of absorption costing since, with one exception, none of them would be encountered except when changing from the latter to the former method of costing. The one exception is the case of a newly formed company. A newly formed company should find none of the disadvantages

insurmountable. The established company attempting to convert from absorption costing will find all of the disadvantages present, but again not insurmountable.

NAA Research Series No. 23 on Direct Costing lists the following as disadvantages of direct costing:¹

1. Difficulty may be encountered in distinguishing the fixed costs. In particular, certain semivariable costs may fall in a border-line area and more or less arbitrary classification may be considered necessary in order to arrive at a practical determination of fixed and variable components.
2. Complete manufacturing cost is not determined in the process of costing production and supplementary allocation of fixed overhead on normal or some other volume base must be made to provide product costs for long-range policy decisions.
3. Serious income tax problems may be encountered if a change is made from full cost to variable cost for costing inventory and definite rulings are not available for guidance.
4. Some accountants question the acceptability of direct cost as a basis for costing inventory in financial statements prepared for stockholders and the public at large. However, extensive interest in direct costing has arisen very recently and opinion with respect to this question has not crystallized at the present time.

Perhaps the criticism most frequently used against direct costing is that it will lead to a disregard for the need to recover all costs, including fixed costs, in pricing products. Advocates of direct costing believe that, on the contrary,

¹NAA Research Series No. 23; Op. Cit., p. 233.

better pricing will result because management will be more able to understand the relationship between costs, volume, prices and profits.¹

¹Ibid. p. 216.

CHAPTER IV

MANAGERIAL USES OF DIRECT COSTING

Profit Planning and Product-Profitability Analysis

Management encompasses the joint functions of planning and control, involving in the former, the choice of action aimed at achieving some combination of goals.¹ Accounting provides an important part in the presentation of information needed by management for decision making, and costing is a most fertile zone of the accounting portion of management's control systems.

In planning, the direct cost concept provides management with a means of evaluating alternative possible actions in a way which is consistent with the economic facts, freed from the traditional accounting assumptions of "normal" capacity.² Direct costing can be a powerful analysis tool for management in both manufacturing and service industries. It can enable management to differentiate between costs which vary directly with volume and costs which remain fixed without regard to volume. Direct costing is particularly applicable in the age of computerization.

¹Gordon Shillinglaw, Cost Accounting--Analysis and Control (Homewood, Ill.: Richard D. Irwin, Inc., 1967, Rev. ed.), p. 746.

²I. Wayne Keller, "Controlling Contribution", NAA Management Accounting, June 1967, p. 47.

Direct costing is specifically designed to accommodate variances in volume, capacity, price and cost. Almost every business decision of choice between alternate possible courses of action is likely to need analysis involving a distinction between fixed and variable costs.

Profit planning usually leads to increased profits for those managers adept at practicing it skillfully. The direct costing concept can be used in developing and coordinating the many sales and cost targets which must be gathered together to form the overall profit plan. In the broad control area, it is necessary to be able to compare actual results with expectations in order to evaluate performance.

To be effective a profit plan must be measured against the return-on-investment or residual income target stipulated by top management. The marketing plan or sales forecast is naturally the starting point for the profit plan. From this forecast of sales must come the financial, production, distribution, and other plans which make up the total profit planning of top-level management. The marketing plan should be concerned with what products to sell, in what volume, and at what prices to sell them. The answers to these questions can then be closely tied in with the corresponding changes which they make on the profit to the company.

Since unit profit contribution for a particular product remains constant in the direct costing approach, answers to the

above questions are readily available to the decision-maker who uses direct costing. To obtain the total contribution to profit simply multiply the planned sales for each unit times the constant rate of contribution. The total contribution of each product can then be compared to the others as a basis for making the best marketing decision. Figure IV-1 shows how marginal income analysis can assist management in determining the most advantageous sales mix for various products.

Fig. IV-1 Profit Contribution Analysis

	A	B	C	D
Target sales	\$4,300	\$1,850	\$2,000	\$1,400
Variable Direct costs ...	<u>3,000</u>	<u>1,200</u>	<u>1,450</u>	<u>750</u>
Profit contribution.....	1,300	650	650	650
Profit Contribution %	30.2	35.1	32.5	46.4

Assume management is planning a \$100,000 sales promotion and is trying to decide upon which of the products in figure IV-1 to emphasize. Without careful analysis, product A might seem to be the most profitable since it is making the biggest profit contribution of the four products in total dollars. However, product D produces the highest rate of profit contribution. It has the least sales volume, but assuming that there is room for market expansion, it clearly offers the most attractive profit

opportunity. This is true even though it contributes only the same total amount to profit as products B and C. This would also hold true if the profit contribution of product D is less than each of the other products. In product D sales increase of only \$215,517 would recover the promotion costs of \$100,000 and all variable costs of producing that amount of product. Increased sales of \$331,122 of product A would be required to recover the same promotion costs. Products B and C would require \$284,900 and \$307,700 additional sales respectively to recover variable costs of their production plus the \$100,000 promotion costs. Under direct costing the profit contribution and percentages can be obtained directly from the operating and income statement to make decisions similar to those illustrated above.

Cost-Profit-Volume Relationship

"An understanding of the relationships between costs, volume, and profits enables management to choose its objectives on a more realistic basis and to make decisions with greater assurance that objectives will be reached."¹ Direct costing develops factual information about the behavior of costs and profits under conditions of changing volume which can be presented to the manager for decision making. This is because direct costing distinguishes between fixed and variable costs for profit and loss statement presentation. Absorption costing does not make this distinction on the profit and loss statement. Consequently, supplementary

¹NAA Research Series No. 23: "Direct Costing" in NAA Selected Papers, ed. by Marple, p. 186.

statistical studies and analyses are usually required under the absorption method of costing to provide management with the necessary information in reaching decisions concerning cost-profit-volume relationships.¹ Such supplementary information includes flexible budgets, break-even charts and studies showing marginal cost and income analyses.

Volume is one of the key factors which must be considered in profit planning. Volume is a consideration in decisions involving pricing products, deciding the amounts to spend on advertising, whether to drop product lines or add new ones, and in making capital expenditures.

Pricing Products

There is no doubt that the direct costing concept is not only useful but indispensable in pricing products.

In multi-product pricing, management needs to know whether each product can be competitively priced in the industry and still contribute sufficiently to direct profits, that is, fixed cost absorption and real profits to justify keeping it in the price list. Furthermore, it is necessary to be prepared to move the price along with technological improvements toward that point where marginal revenue equals or approximates marginal cost and, thereby, attempt to maximize profits.²

Direct costing provides more relevant information concerning pricing policies than does absorption costing. This is true because the information furnished is not obscured by the allocation of fixed costs. Many times management may find it

¹Ibid.

²J. H. Rushton, Op. Cit., p. 113.

advantageous to sell at prices that will cover any portion of the fixed costs of the firm. This can be done as long as the selling price is set to exceed the variable costs, no matter how small the excess. Thus direct costing provides the manager with ready tools to evaluate effects of price cutting necessitated by competition.

Pricing will usually not be based on costs to the manufacturer of producing his goods, but rather, will be determined in the market place, i.e., by competition. The value of determining the cost of products is to allow the decision-maker to decide whether he can compete with specific products and with which products he can compete with maximum results to the profitability of his firm. Competition may be of many types, of which price is but one, still pricing decisions must be made in varied situations such as new products, excess capacity, and market leadership. The best cost information available provides management with a benchmark, showing available latitude, and knowledge of attributable costs, which reflect the extent of unit cost variability, and which must exert the greatest influence.¹

Since direct costing corresponds closely with the current out-of-pocket expenditures for a product, it can point out the marginal products and territories to management for their prime attention and time. Thus direct costing can point management toward management by exception in this area.

¹D. R. Rickard, "A Practical Application of Direct Costing," A.I.C.P.A. Bulletin, October-December, 1964, p. 73.

Better Profit and Loss Statements

Neikirk believes "the outstanding effect of direct costing will be found in the resulting profit and loss statement which segregates fixed and variable costs."¹ He claims that the profit-volume analysis provided by such a profit and loss statement, along with the resultant more realistic and understandable picture of operations sustained during the accounting period, will be an invaluable aid for management decision making.

Neikirk uses the following example of a profit and loss statement using absorption costing to illustrate his contention for segregating fixed and variable costs:²

	January	February
Sales	\$300,000	\$300,000
Cost of sales (including factory overhead at standard burden rates...	<u>246,000</u>	<u>246,000</u>
Gross Profit	<u>54,000</u>	<u>54,000</u>
Selling expense	20,000	20,000
General and Administrative expense ...	19,000	19,000
Over-and under-absorbed burden	<u>(5,400)</u>	<u>8,100</u>
Total	<u>33,600</u>	<u>47,100</u>
Net operating profit	<u>\$ 20,400</u>	<u>\$ 6,900</u>

The operating profit is three times greater in January than in February even though sales were identical for the two periods. The reason for this is that production in January was at a high

¹Neikirk, "How Direct Costing Can Work for Management," in NAA Selected Papers, ed. by Marple, p. 81.

²Ibid. p. 82.

rate. In January factory overhead costs were not only fully absorbed by produced units, but were over-absorbed to the amount of \$5,400 which resulted in a deduction to the overall expenses for the period resulting in a larger profit for the period. The question is whether production should be allowed to influence profit without regard to sales volume. Note that if production had been the same in each month the reported profits would have been the same for both periods. It is easy to see that absorption costing causes reported profits to follow production as well as sales.

Conversion of the profit and loss statement to one using the direct costing concept would produce better information to management concerning the relationship between profit and volume. Consider figure IV-2 which is a condensed profit and loss statement from Neikirk's article in a 1951 NAA Bulletin.¹ It is arranged in descending order of variability of the different classes of expense. This type of presentation facilitates analysis of the relationship of profit to volume for any period.

The standard direct cost of sales is subtracted from gross sales to arrive at a "Gross Margin above Direct Cost" figure. This deduction includes only the variable manufacturing cost of goods sold. From this figure is deducted the variable sales returns, allowances, freight, etc., to arrive at a "Net Gross Margin." Deduction of the selling expenses are made to arrive

¹Ibid. p. 85.

at a "Merchandising Margin." Only then are the fixed overhead expenses considered. "A quick analysis of the break-even point

Figure IV-2

CONDENSED PROFIT AND LOSS STATEMENT
Illustrating Use of Direct Costing

	Actual	Budgeted	Budget Comparison Favorable (Unfavorable)
Gross sales	\$2,810,000	\$2,670,000	\$ 190,000
Standard direct cost of sales	<u>1,610,000</u>	<u>1,510,000</u>	<u>(100,000)</u>
GROSS MARGIN ABOVE DIRECT COST	1,200,000	1,110,000	90,000
Deductions for returns, allowances, etc.....	<u>79,000</u>	<u>75,000</u>	<u>(4,000)</u>
NET GROSS MARGIN	<u>1,121,000</u>	<u>1,035,000</u>	<u>86,000</u>
Selling expenses	<u>255,000</u>	<u>240,000</u>	<u>(15,000)</u>
MERCHANDISING MARGIN..	<u>866,000</u>	<u>795,000</u>	<u>71,000</u>
Overhead expenses:			
Indirect factory exp..	279,000	275,000	(4,000)
Research & Development	118,000	120,000	2,000
General Admin.....	109,000	110,000	1,000
Factory variances and adjustments	<u>26,000</u>	<u>25,000</u>	<u>(1,000)</u>
Total overhead exp....	<u>532,000</u>	<u>530,000</u>	<u>(2,000)</u>
OPERATING MARGIN	<u>334,000</u>	<u>265,000</u>	<u>69,000</u>
Other income or charges, net	<u>20,000</u>	<u>20,000</u>	<u>-</u>
PROFIT BEFORE TAXES ..	<u>314,000</u>	<u>245,000</u>	<u>69,000</u>
Allowance for taxes	<u>141,000</u>	<u>110,000</u>	<u>(31,000)</u>
NET PROFIT	<u>\$ 173,000</u>	<u>\$ 135,000</u>	<u>\$ 38,000</u>

can be made by simply dividing these overhead expenses by the percentage that merchandising margin is of gross sales."¹ No over-or under-absorbed burden will exist no matter at what volume the factory is operating. Since fixed expenses are

¹Ibid.

segregated from variable expenses any sales volume can be projected to determine the resultant net profit which would be produced at that particular volume of sales. In other words, a break-even analysis is readily available without special analysis charts or statements.

Since the direct cost of a product is really the out-of-pocket costs of production, when this figure is readily available for each product, territory, or salesman, management is made aware of the contribution which a product's sale will make to fixed expenses. The company is better off producing and selling a product as long as some contribution is being made to cover fixed costs. It should be pointed out that analysis relating to specific profit and loss statements should only be applied to short-run decisions since in the long-run sunk or fixed costs can be changed by management. It is also true that special studies can be presented to show the same information for analyses that appears on a profit and loss statement under the direct costing concept. However, this is one of the advantages of direct costing, that profit-volume analysis is presented on the statement itself, thus eliminating the need for special statistical and clerical work.

Another advantage to management of a profit and loss statement based on the concept of direct costing is that expenses are grouped for control. The merchandising margin represents the contribution of the sales department to fixed expenses of the company. All expenses other than variable and sales expenses

are shown in figure IV-2 below the merchandising margin line. These are the expenses which must be covered if the company is to be profitable and thus remain in business. The degree of classification into fields of responsibility is a decision for management based on the organization of the particular firm and the need for control within the organization.

From management's viewpoint still another advantage of profit and loss statements prepared under the direct costing concept is that "a flexible budget is automatically established for the variable costs of each individual product, based on current conditions."¹ Budgets can be compared directly with actual results on profit and loss statements such as that shown in figure IV-2.

Nickert advocates simplicity in presentation of results as another benefit of presenting the profit and loss statement to management under the direct costing concept. He states:

Here on one sheet is a complete picture of operations, divided by responsibility, with each group measured against a predetermined standard or budget. Fixed expenses are shown separately instead of being buried in cost of sales. The statement shows the direct contribution which sales make to the company's fixed expenses.²

Alternative Decisions

The gulf between managers and proprietors is widening. There was a time when the proprietor was the manager. Now

¹Ibid., p. 87.

²Ibid., p. 88.

professional managers are employed to run the business concern in increasing numbers. He will not be allowed the luxury of trial-and-error decision making afforded the owner-manager of the past. The closer to the top hierarchy of management one ascends the more applicable the above statement becomes. This is one of the primary reasons why the present-day manager must be fully aware of all aids which will assist him in reaching business decisions involving alternate choices. The amount of data generated in most business organizations is enormous. Evans and Hague point out that "...in U. S. industry today, the gathering, storing, manipulating, and organizing of information for managing enterprises cost as much or more than does direct factory labor."¹ The skillful manager must know which to discard, or better still, stop, in order to get at the pertinent data.

Yet, to many managers such terms as cost-volume-profit relationships, discounted cash flow, contribution margin, break-even point, marginal cost, etc., are vague terms which can be turned over to the "specialists" to worry about. This type of manager probably will not survive in the future. More appropriately, the firms who hire such managers in the future will be unable to survive in the competitive world ahead.

Perhaps some of the blame lies with accountants for their failure to show interest in educating management in the area of accounting. Accountants have provided the information to

¹Marshall K. Evans and Lou R. Hague, "Master Plan for Information Systems," Harvard Business Review, Vol. 40, No. 1, Jan/Feb., 1962, p. 87.

management, but have not followed up to insure that the data has been interpreted properly by the user of the furnished information. Some would argue that it is not the role or duty of the accountant to go beyond providing the raw data for top level management decisions. The role of staff personnel is to assist management. Inherent in the staff role is not only the presentation of data in such a manner that it is easy for management to interpret but to assist them in gaining insight into new methods for analyzing alternative choice decisions. Direct costing is one area in which the accountant has missed a golden opportunity to influence management.

CHAPTER V

ACCEPTANCE OF DIRECT COSTING

Acceptance by Management

Literature on direct costing indicates that management will willingly accept it as a replacement for absorption costing.¹ It provides them with more understandable cost information in terms familiar to their everyday language. The manager is ever seeking means for reducing costs. He sees direct costing as a means of reducing paperwork. Cost-volume-profit relationship data needed for profit planning purposes is readily obtained from the regular accounting statements produced from direct costing. Therefore, management does not have to work with two or more separate sets of data to relate one to the others. A system which shows potential for saving management time, money, and effort to an organization is hard to oppose from a managerial standpoint.

Management has long had difficulty in understanding the under and over-absorbed variances of cost accounting. A

¹George T. Logan, Jr., "The Direct Costing Controversy," Management Accounting, Sept. 1968, Vol. XLX No. 1, p. 9.

mere mention of total elimination of these phantom demons of his past experiences insures that management listens with a sympathetic ear to the feasibility of installing a more understandable system of costing within the organization.

The idea of receiving faster cost information is also appealing to management. If during the middle of an accounting period actual sales are differing significantly with forecasted sales a "flash" income report can be produced projecting income from a newly estimated sales forecast. The income statement itself will make more sense to management when presented under the direct costing concept. Manufacturing cost and income statements in the direct costing form follow management's thinking more closely than do statements presented under the absorption method of costing.

Management, generally speaking, has always expected profits to be in relation to the volume of sales for a given accounting period instead of relating to production volume for the same period. Direct costing insures that profits do follow sales. Under direct costing the profit for a period is not affected by changes in absorption of fixed expenses resulting from increasing or reducing inventories.

Management readily accepts marginal income figures which facilitate relative appraisal of products, territories, classes of customers, and other segments of the business without having

the results obscured by allocation of joint fixed costs. The impact of fixed costs on profits is emphasized because the total amount of such cost for the period appears in the income statement. The breakeven point will be obvious from the income statements produced under direct costing.

Communication between managers, accountants, supervisors, and staff personnel will be apparent to management from the revised income and expense statements which are no longer confused by technicalities. Management can take advantage of these more prompt, reliable, and comprehensive reports.

Direct costing ties in with such effective plans for cost control as flexible budgets and standard costs. Management is taking advantage of direct costing, but only from an internal standpoint in most instances. Indeed, it is not the manager who is not willing to accept direct costing. He is the recipient of many of the advantages resulting from direct costing even where absorption costing is used. The difference is that under absorption costing systems, additional statistical compilations and reports are produced for management. These additional reports are both costly and time consuming and could be avoided by the installation of direct costing to replace absorption costing. Why then, does management not arbitrarily direct implementation of direct costing to replace absorption costing in view of all its relative merits? The

answer is that what is acceptable to them is not so readily acceptable to those in position to make the necessary changes at the working level, nor is it acceptable to those who determine the legality of its effect on inventory valuation. These points will be the subject of the remainder of this chapter.

Acceptance by the Internal Revenue Service

Federal taxation on corporate income became significant in the mid 1930's.¹ Since then taxation of income has had a great deal of influence on accounting. "Given that a tax is to be levied on income, accounting for that income becomes critical for the very obvious reason that the amount of tax to be paid is a direct function of the amount of income."² The area for concern, insofar as taxes are concerned, is inventory valuation.

Federal tax regulations fail to provide clearcut guidance in the area of which overhead items should be included in the valuation of inventories.³ The Commissioner's regulations define the cost of goods manufactured as including:

¹Dwight R. Ladd, Contemporary Corporate Accounting and the Public, (Homewood, Ill.: Richard D. Irwin, Inc., 1963), p. 45

²Ibid.

³A. N. Davidson, "Acceptance of Direct Costing," Management Accounting, March 1970, Vol. LI, No. 9, p. 35.

...indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital....¹

NAA Research Report No. 37 entitled "Current Applications of Direct Costing" reviewed three cases touching on the issue of direct costing. However, their final conclusion was "that the propriety of direct costing as an inventory costing method was not at issue"² in any of the three cases. Their conclusion, naturally, was that these three cases shed no light on the acceptance or non acceptance by the tax authorities of direct costing in inventory valuation.

In 1967 the Dearborn Gage Company, in 48 TC 190 presented an interesting case where the company had included only the cost of direct labor and direct material in inventory. They charged overhead to the period during which it was incurred. The Commissioner of Internal Revenue ruled that this was improper and that inventories would have to be corrected by the addition of overheads to inventory values. The Tax Court agreed and Dearborn was forced to shift to absorption costing.³

Seemingly, the Dearborn case ruling against direct costing was clearcut. However, this is far from being a correct assumption. The Dearborn case was one of prime-to-absorption

¹Neikirk, Op.Cit., p. 92.

²Davidson, Op. Cit., p. 36.

³Ibid.

costing as the term direct costing is generally understood.

"Direct costing--or as it is otherwise known, variable costing or marginal costing--refers to the aggregate of costs that may vary with the level of operations."¹ Direct costing would include certain overhead costs as well as including prime direct labor and material. Prime costing can be thought of as a subset of direct costing. The Dearborn case also was of no help in determining an official position on direct costing from the Internal Revenue guidelines.

A case which is more closely associated with the direct costing method of inventory valuation is McNeil Machine and Engineering Company versus United States, Ct. Claims Commissioner's Report, 3/29/67. Code section 446 "General rule for methods of accounting," and code section 471, "General rule for inventories" were the legal codes used in deciding whether direct costing was an acceptable inventory valuation method reflecting correct net income. The Trial Commissioner found that the company method of costing clearly reflected income. He ruled that it was a correct method because:

- (1) it had been consistently applied over a lengthy period of time (...);
- (2) it represented an inventory valuation method supported by a substantial body of accounting authority and practice, and
- (3) it was in conformity with the income tax regulations.²

¹Ibid.

²Ibid., p. 37.

Consistency is emphasized in both the regulations and in court cases involving inventory valuation using direct costing. Quite probably a new company could adopt direct costing at the outset of its operations and would encounter no opposition from the Internal Revenue Service. Of course, in its case, the question of consistency would come up only if it chose later to change from direct costing to absorption costing. Normally, however, the situation is just the opposite and the question of consistent inventory valuation is material.

There are four courses of action open to the company wishing to change from absorption costing to direct costing. They are:

1. For the purposes of the interim reports, the ... company could follow the direct costing method and, at year end, determine the amount of fixed factory expenses in inventory by means of a broad in toto expense allocation and redistribution. This amount would be carried throughout the year at the same value and, at the end of the next period, recalculated to determine the increment or reduction for the effect on profit for tax purposes. If this plan were adopted, additional calculations should be made, either monthly or quarterly, in order to keep management informed of the trend.
2. Another possibility would be to obtain permission from the tax authorities to establish an amount representing the fixed factory expenses incurred to create a working or normal inventory. This amount would not be changed from year to year unless there were a permanent change in the nature of the business or the capacity to produce.
3. The third alternative would be to request permission

from the Bureau of Internal Revenue to go all the way and eliminate the factory fixed expenses from the inventory. Whether this permission would be forthcoming is questionable and the outcome might necessitate adoption of the fourth possibility.

4. Fixed factory expenses would be eliminated from inventory valuation for corporate accounting but retained in inventory valuation for purposes of tax accounting.¹

Most organizations adopting direct costing have followed course of action number four listed above. This seemingly involves keeping two sets of books. Is two sets of books really necessary? The answer is no. The question in inventory valuation is one of consistency. Any company using either method of costing is equally concerned with consistent reporting of inventory valuations. Under either system inventories can be reflected at full cost for profit determination at the close of the period. There are several methods of converting to full cost inventory valuations at the end of the accounting period to provide this consistency in inventory valuation for external reporting.² The important point is that acceptability or nonacceptability by the Internal Revenue Service should not be the deciding factor in management's choice of a management accounting system.

There is no doubt that the fact that the Internal Revenue Service does not accept direct costing for inventory valuation

¹Luenstroth, Op. Cit., pp. 106-107.

²See Ray E. Longenecker, "Converting to Direct Costing," in Marple, ed., Op. Cit., p. 364. And Lynch, Op. Cit., pp. 303-304. Also Matz, Curry and Frank, Op. Cit., p. 794.

is a major factor preventing its adoption by many companies to replace absorption costing. It is easy to see that at the time of changeover from absorption to direct costing, a loss of tax revenue would result in the changeover year. This is because expenses for that period would include period costs for that period in addition to those fixed cost which were lodged in the beginning inventory.

On the other hand, there is little doubt that all newly formed companies can adopt the direct costing form of cost accounting without fear of being challenged by the tax authorities. In time this fact alone could dilute what is now generally accepted accounting practice in regard to cost accounting. The more companies utilize the direct costing method, the more likely and faster it will become accepted for external reporting.

The Internal Revenue Service is prone to accept what is considered "generally accepted accounting practices." And generally accepted accounting practices are prone to be that which has been past custom. More specifically, what is generally accepted to the Internal Revenue Service is what is acceptable to the accounting profession. As will be seen later, the American Institute of Certified Public Accountants normally determine for the accounting profession, what constitutes generally accepted accounting practices.

Acceptance by the Securities and Exchange Commission

The Securities and Exchange Commission takes a view toward direct costing almost identical to that of the Internal Revenue Service. Direct costing is acceptable to the SEC if it has been used consistently by the company. However, "even in those cases where inventory valued under direct costing has been accepted, the SEC has usually required that a note be attached to the Statement if the inventory previously computed by the conventional absorption costing method would result in significant changes in income or balance sheet figures."¹

Thus, like the Internal Revenue Service, the Securities and Exchange Commission accepts what is considered "generally accepted accounting practices," and changing custom is sometimes difficult indeed. The key to changing historical based accounting practices is in influencing the professionals in the field. This means influencing the American Institute of Certified Public Accountants.

Acceptance by the Accounting Profession

It is universally recognized that the determination and reporting of income is of vital importance to the creditors

¹Ibid., p. 793.

and stockholders of any business enterprise. Creditors and investors use reported income to measure economic progress in the past and apply it, along with other information, to form opinions on the prospects for the future. Income plays a vital role in maintaining the equilibrium and progress of our free enterprise system by systematically feeding capital to those areas which promise the most return. Thus, there are requirements for valid cost reporting systems to feed needed data to management in order to properly report the income for a business enterprise.

Historically, the determination of net income for external reporting has relied upon the absorption method of costing products in accordance with the generally accepted interpretation of the matching concept. Now direct costing has forced an issue for determination by the accounting profession. The issue is whether or not direct costing is to be considered as acceptable accounting procedure. "It is time for accounting organizations to take a position on the merits of direct costing...."¹ As stated previously, there is no issue so long as the firm uses direct costing for internal purposes only. However, only when direct costing is accepted for external reporting will management gain its greatest benefits from direct costing.

¹Davidson, Op. Cit., p. 37.

Who is to settle this issue? It is clear that management would prefer the use of direct costing. It is also clear that, while the Internal Revenue Service and the Securities and Exchange Commission do not generally sanction the use of direct costing for inventory valuation, their objections can be overcome by the accounting profession. Basically all the profession must do is approve the method of direct costing themselves. This is not so simple a task.

Accounting Research Bulletin 43, issued by the American Institute of Certified Public Accountants in 1953, effectively ruled out the use of direct costing in published financial statements with the following pronouncement:

The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of applicable expenditures and charges directly or indirectly incurred in bringing an article to its condition and location. The exclusion of all overhead from inventory cost does not constitute an accepted accounting procedure.¹

Most important of all the groups of accountants are the public accountants, mostly represented through the American Institute of Certified Public Accountants. They certify the statements of most of our large corporations and are influential in all aspects of accounting. The Accounting Research and Terminology Bulletins of their American Institute of Certified

¹Logan, Op. Cit., p. 11.

Public Accountants collectively represent the closest thing to an authoritative statement of what should be contemporary accounting principles and procedures. The AICPA has no legal authority in the field of accounting to establish procedures and principles over the profession or industrial accounting in general, however, by "general acceptance" they have been looked to for guidance in the accounting profession.¹ Final authority, however, rests with management of individual companies. There is little uniformity in accounting from one firm or industry to another. In essence, when the auditor signs the corporate financial statements, he simply passes judgment on the validity of how well management represented the financial statements and facts to the public.

It is from another group of accountants that we must place our hope for change upon. This, the largest group of accountants, is the working accountants. They are the employees of business, nonprofit organizations, and governments. They comprise such groups as the National Association of Accountants and the Financial Executives Institute. They are the people involved in managerial accounting. They provide the data on which management make decisions. They are directly involved in cost accounting. And it is these

¹Ladd, Op. Cit., pp. 161-163.

working professional accountants who must influence the professional public accountants who audit their financial statements of the necessity for change in the area of costing.

CHAPTER SIX

CONCLUSIONS

There has been much disagreement in writings and discussions concerning the merits of direct costing versus absorption costing. Many accountants advocate that direct costing replace the "full" or absorption method of cost accounting. There are others who claim that absorption costing is the only valid means of inventory valuation and, thus, the only correct cost accounting method.

Most accountants, however, would agree with management that, conceptually, the logic underlying direct costing is sound. Few would challenge the fact that it has an important role in the field of management information and that management should be aware of its usefulness. Nor would many accountants disagree with the fact that the "direct costing" thought process is indispensable to sound management decision making.

In its narrow and more common aspect, i. e. product costing, direct costing provides a logic which coincides with the economic facts.¹ Within practical limits, there are costs which are more-or-less fixed, regardless of production and

¹Leonard A. Doyle, "Overhead Accounting Comes Full Circle," Contemporary Issues in Cost Accounting (Boston: Houghton Mifflin Company, 1966), pp. 141-150.

sales activity, and these costs must be covered out of the margin available from income from sales, after the direct product costs such as labor, material and factory overhead are deducted. Thus, each sale or order may be viewed as providing a contribution towards those fixed costs, which must be fully covered. Direct costing brings essential facts to the manager's attention more effectively than absorption costing.

It is important to remember that, in the long run, both costing methods render the same profit results. It all boils down to one basic difference. Direct costing treats fixed costs of manufacturing as period costs while absorption costing treats the same costs as product costs.

While hundreds of companies do use direct costing, there has been no great rush to realize its full benefits by replacing absorption costing with it and thereby using direct costing for external reporting purposes.¹ Direct costing is not alone as a management accounting concept which is invaluable to the manager in the decision making process, yet is not used in external financial reporting because they do not fit the "general acceptance" for financial reporting requirement. Other concepts in this category are:

1. Replacement cost
2. Price level adjustments
3. Discounted cash-flow techniques

¹Solomons, Op. Cit., p. 101.

4. Opportunity costs
5. Market valuation of current assets¹

Generally, direct costing has become associated with such varied topics as product costing, inventory valuation, contribution reporting, presentation of operating results and others. However, it is principally a concept in the presentation of cost-volume-profit relationship.² Since overhead costs are the least certain of all types of manufacturing costs in their degree of variability, it is appropriate that direct costing should concentrate on their significance to managerial decision making.

One must conclude that direct costing will not soon replace absorption costing as the preferred costing method in business enterprise. The reason is not that direct costing is an inferior or inadequate method of costing. Rather, it is the fact that it does not meet what is considered generally accepted accounting practices which accounts for its failure to replace absorption costing.

The absorption costing method has been self perpetuating. The techniques used in practice reflect what accountants have been taught in learning their professions. Text-books teach absorption costing. Students are exposed to a brief mention of direct costing if at all. One has only to pick up text-books on cost accounting to verify this. There are some notable exceptions.

¹Richard A. Hamburger, "Management Accounting Concepts and the Principles Dilemma," Management Accounting, April 1969, Vol. L, No. 3, p. 14.

²NAA Research Series No. 23, Op. Cit., p. 216.

C. T. Horngren's cost accounting textbook is widely used in the academic field. Horngren is not enamoured to absorption costing and the traditional methods of allocating overhead. He advocates direct costing for pricing purposes and the contribution margin for managerial evaluation and control. Another author, David Solomons', view is "that absorption costing is to be preferred for measuring performance while direct costing does a better job in the planning area."¹ Mainly, however, management accountants have been the chief proponents of direct costing. Accounts in public practice or in a teaching situation have not been exposed to the day-to-day management needs in the area of costing. Generally, they have little experience in the management field of accounting. Thus, they are less likely to become converts to the direct costing concept than are management accountants.²

Who is to blame for our narrow view toward cost accounting--that only fully absorbed costs are generally acceptable? The answer is everyone involved: the accounting profession, the universities who teach, and the corporate users of the accounting techniques and professionals. The business enterprise wants accountants who are useful. The profession and the universities seek to satisfy this need. The need is satisfied by the study and application of techniques currently available to accountants. And what is available to them? Techniques steeped in the traditions of acceptability, or more direct, absorption costing.

¹Solomons, Op. Cit., p. 114.

²Logan, Op. Cit., p. 9.

It is natural to desire progress in any profession. Yet progress is often conveniently interpreted as adding to the existing stock of techniques rather than questioning, and if necessary, abandoning those already in use.

Absorption costing is so ingrained in the traditions of cost accounting that to espouse anything different has been to walk on the ledge of heresy. Yet modern accountants, both academic and professional, must question and doubt methods which no longer do more than justify traditional methods. Some do. Davidson points out that "it is time for accounting organizations to take a position on the merits of direct costing....The NAA could well provide professional leadership with a new study (on direct costing)."¹

In reaching a conclusion as to whether direct costing or absorption costing is better, one must keep in mind the needs of management and not the needs of the accountant. It is the conclusion of this writer that the advantages of direct costing far outweigh its disadvantages and that it is a superior method of costing when compared to absorption costing. Furthermore, tradition rather than logic has prevented its widespread use and acceptance by U. S. business enterprises. As Chapter Five pointed out, management readily accepts direct costing since it is highly oriented toward providing them with timely and efficient information on which to base managerial decisions.

¹Davidson, Op. Cit., p. 37.

The McNeil Machine Engineering Company vs. United States case, cited in Chapter Five, indicates that "when the issue of direct costing is squarely before the courts as a tax matter, it is likely that decisions favorable to direct costing will result."¹ It can be concluded that even though, in some cases, the Internal Revenue Service and the tax courts have attempted to force taxpayers to change to absorption costing, they do not constitute a barrier to the adoption of direct costing in themselves. That is, they are likely to look to the accounting profession for guidance in their rulings and interpretations concerning direct costing.

The Trial Commissioner in the above case, after a careful study into the background of direct costing came up with the following conclusions:

1. In surveying the accounting authorities, the AICPA position on direct costing was found, via Accounting Research Bulletin 43, to be neutral--not indifferent but neutral.
2. Direct costing methods of accounting were being adopted by an increasing number of companies.
3. There was no official proscription of direct costing.²

These observations lead to the conclusion that the future of direct costing will be toward a trend for greater usage. Also, in that some levels of the accounting profession have taken somewhat of a neutral position on direct costing, the avenue is open to eventual acceptance by the profession of direct costing

¹Ibid.

²Ibid.

as a generally accepted accounting practice. What constitutes generally accepted accounting practices is often that method by which accounting is presently being accomplished or that which has been traditional. Thus, the trend toward its gradual increasing popularity will enhance its chances for acceptance.

As was pointed out in Chapter Five, the Securities and Exchange Commission, like the Internal Revenue Service and the tax courts look mainly to consistency and "generally accepted accounting practices." And, like the IRS, the SEC will look to the accounting profession for guidance as to what constitutes generally accepted accounting practices.

The direct costing controversy boils down to an issue of accepting change by the accounting profession. One author summed up the issue thusly:

The antagonists in the direct costing controversy live in different worlds. In one world is the management accountant who tends to accept what is useful to him and to discard what is not useful, without much concern for doctrine. In the other world is the public practitioner or teacher, whose predominant concern of necessity is theory. The result is that the theoretical framework of accounting is built by people who are not necessarily experienced in the area where the theories are most likely to break down.

As in any profession, the real test of theory is how well it works in practice. The largest area of accounting practice is internal corporate reporting. Internal reports go to non-accountants. Non-accountants understand the reports better when they are based on direct costing. For the matter, so do accountants. Accounting theories, if they are to serve any useful purpose, must take this fact into account.¹

¹Logan, Op. Cit., p. 12.

Direct costing is here to stay. Its future is assured in that it is being increasingly used by business firms. However, until it is accepted by the accounting profession, in particular, the American Institute of Certified Public Accountants, its importance will be slight and its growth slow.

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